

## MEMORANDUM

TO: Office of the City Attorney, City of San Diego

FROM: Arto C. Becker, Hawkins Delafield & Wood LLP

DATE: April 20, 2008

RE: Public Facilities Financing Authority of the City of San Diego Lease  
Revenue Bonds, Series 2008A (Various Capital Improvement Projects)

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The City of San Diego, California (the "City") proposes to finance capital projects<sup>1</sup> in the City with proceeds of a bond issuance, which bonds will be payable from lease rental payments to be made by the City (the "Lease Revenue Bonds"). These lease rental payments are to be made under a lease of facilities presently owned by the City, which facilities will be leased to the Public Facilities Financing Authority pursuant to a Site Lease and leased backed to the City under a Lease. Under the Lease, the City makes base rental payments (the "Base Rental Payments") equal to debt service on the Lease Revenue Bonds so long as it has beneficial use of the leased property.

California case law has long established the validity of a beneficial use lease as complying with an exception to the State's Constitutional debt limit. The State's Constitutional debt limit provides that "no county, city, town, township, board of education, or school district shall incur any indebtedness...exceeding in any year the income and revenue provided for such year without the assent of two-thirds of the qualified electors"<sup>2</sup>. One important exception to the constitutional debt limit is for financial obligations that are contingent. The beneficial use leases described in *Rider v. City of San Diego*, *City of Los Angeles v. Offner*, and *Dean v. Kuchel* are the most common application of this exception<sup>3</sup>.

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<sup>1</sup> The Projects consist of the construction, renovation, improvement and equipping of public buildings of the City, facilities for the production, storage, transmission, or treatment of local streets, roads and bridges, including but not limited to street projects, sidewalk/concrete projects, storm drain projects, roofing projects, parking lot resurfacing and overlay, public safety facilities, HVAC projects, plumbing projects, electrical projects, elevator modernization projects, replacement and refurbishment of windows and doors. See Lease, Exhibit A. Each of these projects extends the useful lives of the facilities to which these improvements are made and are therefore considered capital assets for accounting and federal tax purposes. See California Debt Issuance Advisory Commission, "Guidelines for Leases and Certificates of Participation", p. 27 (1993). See I.R.C. Section 1221; 26 U.S.C.A. Section 1221.

<sup>2</sup> Cal. Const., art. XVI, Section 18

<sup>3</sup> See *Rider v. San Diego*, 18 Cal. 4th 1035, *City of Los Angeles v. Offner*, 19 Cal. 2d 483 (1942), *Dean v. Kuchel* 35 Cal. 2d 444 (1950). See also *Mayhew v. County of Sacramento*, 4 Cal App 4th 497 where a contingent obligation that was not structured as a lease financing but rather as an annual appropriation financing was approved by the court, noting that the conditional nature of the obligation was the key factor in validating the transaction.

In *Rider*, the San Diego Unified Port District (the "Port District") and the City entered into a memorandum of understanding for the purpose of expanding a convention center<sup>4</sup>. Under the financing plan, the Port District, a joint powers agency, issued bonds and applied the bond proceeds towards the expansion of the convention center, which also served as the leased property that was the subject of the lease<sup>5</sup>. The court concluded that the two-thirds vote requirement imposed on the City did not extend to the debts of a joint powers agency, which had an existence separate from the City.<sup>6</sup> The court also held that the lease was a contingent obligation and therefore not subject to the State constitution's or City Charter's debt limitation<sup>7</sup>. As set forth in *Offner* and *Dean*, a long-term lease obligation is contingent and not considered an "indebtedness or liability" subject to voter approval if the following conditions are met: (i) the obligation to pay rent each year is contingent upon the lessee having beneficial use and occupancy of the leased premises during that year; (ii) if such use and occupancy is not provided, there is an abatement of rent; (iii) there can be no acceleration of the future rent due in the event that the lessee fails to pay rent; and (iv) the rent in each year represents the fair rental value of the premises<sup>8</sup>. The court in *Rider* held that the arrangement between the Port District and the City satisfied these requirements<sup>9</sup>. Thus, the financing was not in violation of Section 18 of Article XVI of the California Constitution.

The proposed Lease to be entered into in connection with the proposed issuance of Lease Revenue Bonds complies with the principals set forth in *Offner*, *Dean* and *Rider*. First, Section 6.01(c) of the Lease sets forth the contingent nature of the City's obligation to make Base Rental Payments. It provides:

[The] payments of Base Rental Payments ... for each Lease Year or portion thereof during the term of [the] Lease shall constitute the total rental for such Lease Year or portion thereof and *shall be paid or payable by the City for and in consideration of the right of the use and possession of, and the continued quiet use and enjoyment of, the Leased Property.* (Emphasis added.)

Second, pursuant to Section 6.04 of the proposed Lease, rental payments are abated in the event the City does not have beneficial use of the Leased Property. Section 6.04(a) of the proposed Lease provides in relevant part:

Except to the extent of (i) amounts held by the Trustee in the Interest Account, Principal Account or the Reserve Account of the Payment Fund, (ii) amounts received in respect of use and occupancy insurance, and (iii) amounts, if any, otherwise legally available to the Trustee for

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<sup>4</sup> *Rider v. San Diego*, 18 Cal. 4th 1035, 1039.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*, p. 1043.

<sup>7</sup> *Id.*, p. 1047.

<sup>8</sup> *Id.* p. 1047-1049.

<sup>9</sup> *Id.* p. 1050.

payments in respect of the Series 2008A Bonds, *during any period in which, by reason of material damage, destruction, title defect or condemnation there is substantial interference with the use and possession by the City of any portion of the Leased Property, rental payments due [under the Lease] with respect to the Leased Property shall be abated to the extent that the annual fair rental value of the portion of the Leased Property in respect of which there is no substantial interference is less than the annual Base Rental Payments and Additional Rental, in which case rental payments shall be abated only by an amount equal to the difference.* ... Any abatement of rental payments pursuant to [] Section [6.04] shall not be considered an event of default as defined in Article X [of the Lease] .... Such abatement shall continue for the period commencing with the date of such damage, destruction, title defect or condemnation and ending with the substantial completion of the work of repair or replacement of the portions of the Leased Property so damaged, destroyed, defective or condemned. (Emphasis added.)

Third, there is no acceleration of rent in the event of a default (from which abatement is explicitly excluded pursuant to Section 6.04(a) of the proposed Lease, as described above) or a failure of the City to pay rental payments. Further, Section 8.02(b) of the proposed Indenture relating to the Lease Revenue Bonds states: “*[N]either [the] Indenture nor the [Lease Revenue] Bonds provide for the remedy of acceleration of principal or interest* due with respect to the [Lease Revenue] Bonds prior to their stated due dates.” (Emphasis added.) Section 11.01(b)(2) of the proposed Lease, which relates to remedies in the event of default and corresponds to the prohibition of acceleration under the proposed Indenture, states in relevant part:

The Authority or its assignee, in addition to all other rights and remedies it may have at law [in the Event of Default], shall have the option to ... [w]ithout terminating [the] Lease, (i) to collect each installment of rent as it becomes due and enforce any other term or provision hereof to be kept or performed by the City, and/or (ii) to exercise any and all rights to retake possession of the Leased Property. In the event the Authority or its assignee does not elect to terminate [the] Lease in the manner [otherwise provided for in the Lease], the City shall remain liable and agrees to keep or perform all covenants and conditions herein contained to be kept or performed by the City and, to pay the rent to the end of the term of [the] Lease or, in the event that the Leased Property is re-let, to pay any deficiency in rent that results therefrom; and further agrees to pay said

rent and/or rent deficiency punctually at the same time and in the same manner as hereinabove provided for the payment of rent hereunder (*without acceleration*), notwithstanding the fact that the Authority or its assignee may have received in previous years or may receive thereafter in subsequent years rental in excess of the rental herein specified and notwithstanding any retaking of possession of the Leased Property by the Authority or its assignee or suit in unlawful detainer, or otherwise, brought by the Authority or its assignee for the purpose of obtaining possession of the Leased Property....

Finally, the City will represent, based on third-party appraisals of the Leased Property, in the closing certificates delivered in connection with the Lease Revenue Bonds to the effect that annual fair rental value of the Leased Property is not less than the maximum Base Rental Payments payable hereunder in any year. Notably, *Rider* requires only that the terms of the lease be "reasonable", a determination that is to be made by the issuer.<sup>10</sup>

A review of the State's Constitutional debt limit was set forth by the California Court of Appeal for the Third District in *State of California ex rel. Pension Obligation Bond Comm. v. All Persons Interested in the Matter of the Validity of the California Pension Obligation Bonds to be Issued*<sup>11</sup>. Although the case focused on obligations imposed by law as another exception to the State's Constitutional debt limit, the court noted, in a survey of several exceptions to the State's Constitutional debt limit, that contingent obligations are not debt under the State's constitutional debt limit. Notably, the court stated that this analysis has been "applied to uphold multiyear contracts, such as leases..." *Id.* In addition, this case reiterated that the contingency exception also applies to the debt limitation imposed by Section 1 of Article XVI<sup>12</sup>. Similar to its inquiry in regards to Section 18, the court noted that inquiries into the applicability of the exception rest on the contingent nature of the obligation<sup>13</sup>.

In some lease financings, the leased property is the financed property. However, often the leased property is not the financed property. Such leases, like that proposed for the subject financing, are referred to as an asset-transfer lease. While all of the relevant case law on lease financings involves instances in which the financed project is also the leased asset, this is not a requirement for a lease to be excepted from the State debt limit.

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<sup>10</sup> *Rider v. San Diego*, 18 Cal. 4th 1035, 1047. The City's assessment of the fair rental value based upon the nature of the Leased Property, as supplemented by the appraisals commissioned by the City, satisfies the requirement to use current market conditions. See *Wu v. Interstate Consol. Indus.*, 226 Cal. App. 3d 1511, 1515. (holding the "only reasonable interpretation of the term "fair market rental value" as used in the lease is that rent is to be established with reference to the nature of the premises and the purpose for which it has been leased").

<sup>11</sup> *State of California ex rel. Pension Obligation Bond Comm. v. All Persons Interested in the Matter of the Validity of the California Pension Obligation Bonds to be Issued*, 152 Cal. App. 4th 1386.

<sup>12</sup> *Id.* p. 1400.

<sup>13</sup> *Id.*

In *Rider*, the court noted the main Constitutional inquiry is "whether the payments in future years are contingent"<sup>14</sup>.

Moreover, the validity of the transaction is based on the public agency's power to lease property. Significantly, the power of a public agency to lease property is not conditioned upon the use to which the proceeds received for the lease are used. The City's Charter states that the City is a "municipal corporation ... [that] shall have perpetual succession ... may own and acquire property within or without its boundaries for either governmental or proprietary, or any municipal purpose, either by succession, annexation, purchase, devise, lease, gift or condemnation, and may sell, lease, convey, exchange, manage and dispose of the same as the interests of said City may require...."<sup>15</sup>. Thus, like general State law<sup>16</sup>, the City Charter does not establish limitations on the use of proceeds obtained in connection with a lease of property.

Despite the absence of citable cases which directly address asset transfer lease financings, several matters are noteworthy. First, in *United States Trust Company of New York v. Richmond*, the Superior Court of California for Contra Costa County addressed the validity of an asset transfer lease financing for the Richmond Unified School District (the "District"). In the District financing, the school district entered into a lease agreement under which it would make lease payments in consideration of the use of certain school district properties pledged in connection with the financing. The proceeds from the sale of certificates were used to finance the District's operational deficits. The court held that the lease was valid. Focusing on whether the obligations were contingent, the court stated that the "use to which the proceeds of the Site Lease was made is irrelevant to whether the payments under the Lease/Purchase Agreement violate the constitutional debt limitation"<sup>17</sup>. The case has not been ordered published and is therefore not citable in a court of law. Nevertheless, *Richmond* is a significant case to the California public finance bar. Also of note, *Richmond* and its ramifications were discussed in the California Debt and Investment Advisory Commission's Guidelines for Leases and Certificates of Participation of November 1993<sup>18</sup>. The Guidelines noted that the Richmond financing was not representative of school district leasing activity in California because the District issued the certificates to address operating costs and highlighted the fact that the broader validity of tax-exempt lease financing was never questioned.

Following the decision in *Richmond*, the Education Code was amended to codify the holding of the *Richmond* court, expressly authorizing asset transfer lease, although prohibiting such financings for operating expenses on a long term basis. See Section 17456(c) of the Education Code<sup>19</sup>. Thus, while the amendment recognized a need for

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<sup>14</sup> *Rider*, 18 Cal. 4th 1035, 1049. *Mayhew*, 4 Cal. App. 4th, 497, 508.

<sup>15</sup> City of San Diego, City Charter, Section 1.

<sup>16</sup> See Cal. Gov. Code Sec. 37350 and Cal. Gov. Code Sec. 37380.

<sup>17</sup> *United States Trust Company of New York v. Richmond Unified Sch. Dist.*, No. C-92-01580 (Order Granted Dec. 11, 1992).

<sup>18</sup> See California Debt Advisory Commission's Guidelines for Leases and Certificates of Participation of November 1993, pp. 51-52.

<sup>19</sup> Cal. Educ. Code Section 17456.

greater oversight over school finances, it also, in conjunction with the superior court decision, confirms a long history of approving the validity of lease financings without requiring that the financed asset also serve as the leased asset.

I also note that CDIAC's California Debt Issuance Primer, which provides a comprehensive overview of the debt financing alternatives available to public agencies in the State and summarizes major Constitutional provisions affecting public finance, also describes asset transfer financings as commonly used. The primer explains that the asset transfer method of financing "allows a public agency to meet current capital requirements by realizing cash from the value of existing, unencumbered assets."<sup>20</sup> Further, "the asset transfer financings are essentially methods of leveraging public assets and borrowing all or a portion of the public agency's equity in those assets in order to finance other assets."<sup>21</sup>

The exception to the Constitutional debt limit for contingent obligations structured as lease financings is well settled by *Offner, Dean* and their progeny. While there is no authoritative opinion on asset transfer lease financings, the relevant statutes and constitutional analyses focus on the element of contingency of the public agency's financial obligation and not on the use of the proceeds. There is no requirement that the leased asset and financed asset be the same for a lease financing not to be debt under the State's constitutional debt limitation in Article XVI, Section 18 and the City Charter's debt limitation under Article XVII, Section 90. The proposed Lease to be entered into for the proposed issue of Lease Revenue Bonds is structured in compliance with long-standing case law. Accordingly, we are prepared to deliver our standard bond opinion for the subject lease transaction which approves the Lease and other financing agreements in the transaction.

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[T]he sale by the governing board of any school district of any real property belonging to the school district or the lease by that governing board, for a term not exceeding 99 years, of any real property, together with any personal property located thereon, belonging to the school district shall not be subject to any other provision [of the Education Code or Government Code regarding sale or lease of school property] if all of the following conditions are met:

(a) The property is sold or leased to another local governmental agency, or to a nonprofit corporation that is organized for the purpose of assisting one or more local governmental agencies in obtaining financing.

(b) (1) In the case of the sale of school district property pursuant to this section, the school district, as part of that same sale transaction, simultaneously repurchases the same property that is the subject of the transaction.

(2) In the case of the lease of school district property pursuant to this section, the school district, as part of that same lease transaction, simultaneously leases back, for a term that is not substantially less than the term of that lease, the same property that is the subject of the transaction.

(c) The financing proceeds obtained by the school district pursuant to the transaction described in this section are expended solely for capital outlay purposes, including the acquisition of real property for intended use as a schoolsite and the construction, reconstruction, and renovation of school facilities.

<sup>20</sup> *California Debt Issuance Primer*, California Debt Issuance Advisory Commission, p. 170 (2006).

<sup>21</sup> *Id.*